BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
TIGER, INC.)

Appearances:

For Appellant: Joseph C. Kimble
Attorney at Law

For Respondent: Lawrence C. Counts
Associate Tax Counsel

OPINION

This appeal is made pursuant to section 25667 of the Revenue and Taxation Code from the action of the Franchise Tax Board on protests of Tiger, Inc., against proposed assessments of additional franchise tax in the amounts of $636.20, $636.20, and $1,013.23 for the taxable years 1961, 1962, and 1963, respectively. Portions of those proposed assessments resulted from unprotested adjustments, and to that extent are not in issue here,

In 1956 three individuals, Messrs. Reaves, Tumblin, and Rickett, formed a partnership known as Cal-Rock Co., which thereafter engaged in the rock and gravel business in the Bakersfield area. The partnership business was managed by Mr. K. L. Gallup and after 1958 the partners themselves devoted little time to its operation. Prior to 1961, Mr. Gallup conceived and promoted a plan to incorporate the business.

Tiger, Inc. (hereafter "appellant"), was incorporated under California law on January 13, 1961, for the stated purpose of engaging in the rock and gravel business. On January 30, 1961, appellant applied to the Division of Corporations for a closed permit to issue and sell stock. The permit, which was approved on February 2, 1961, authorized appellant to issue a maximum of 7,500 shares oft its authorized capital stock to Messrs. Reaves, Tumblin, and Rickett, and a maximum of 1,935 shares to Mr. Gallup, as consideration for his promotional services to appellant, The permit required as conditions to the issuance of stock to Mr. Gallup that the certificates for any such shares be placed in escrow until further order by the Commissioner of Corporations, and that Mr. Gallup, by written agreement with appellant, agree to waive (1) the right to receive dividends on that stock until the other shareholders had received 5 percent cumulative dividends per year, and (2) the right to participate in any other distribution of corporate assets until the other stockholders had recovered the full purchase price of their shares. These limitations were to continue in effect only as long as required by the Commissioner of Corporations. On February 9, 1961, appellant and Mr. Gallup entered into this required agreement.

The maximum amount of 7,500 shares of appellant's stock was issued to Messrs. Reaves, Tumblin, and Rickett, and 1,935 shares were issued to Mr, Gallup, pursuant to the provisions of tine permit, on February 26, 1961. Messrs. Reaves, Tumblin, and Rickett contributed $75,000 cash to appellant.

On February 27, 1961, appellant and the partnership executed a conditional sales agreement, whereby the partnership transferred all its operating assets to appellant for $500,000 with a down payment of $50,000 cash and the assumption of partnership liabilities amounting to $18,980.88. The balance of the purchase price, $431,019.12, plus 5 percent annual interest on the declining balance, was to be paid in installments of $5,000 per month.

Under the terms of the conditional sales agreement the partnership retained title;' to all of the assets sold pending payment of the entire purchase price, it also retained customary remedies available to a conditional seller in the event of default by the purchaser. No provision was made for subordination of the partnership's rights under the conditional sales agreement to other obligations which might be incurred by appeilant, as purchaser. To date appellant has fulfilled all its obligations under this contract, and has made timely payment of all agreed installment payments.

Since February 27, 1961, the date the partnership assets were transferred to appellant, Kr. Gallup has been general manager of appellant, for which he has received a salary commensurate with that he was receiving from the partnership for his similar management services.

In computing its depreciation deduction for tax purposes appellant allocated $50,000 of the total purchase price to goodwill and the remainder, $450,000, to depreciable assets, The partnership's basis for those assets at the time of transfer was $158,945.92.

Respondent determined that appellant's acquisition of the partnership assets amounted to a tax-free exchange under section 24521 of the Revenue and Taxation Code, and that appellant therefore should have computed depreciation by using the partnership's basis for those assets, Appellant contends that it acquired the partnership's assets in a bona fide sale, which in no way is within section 24521, and that the price which it paid for those, assets became their basis for purposes of computing depreciation,

Section 24521, subdivision (a) of the Revenue and Taxation Code provides:

> No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation and immediately after the exchange such person or persons are in control (as defined in Section 24564) of the corporation. For purposes of this section, stock or securities issued for services shall not be considered as issued in return for property,

"Control" means the ownership of at least 80 percent of the total voting stock and at least 80 percent of all other classes of stock of the corporation. (Rev. & Tax, Code, § 24564.) If the requirements of these sections were met in this case, the property transferred to appellant retained the same basis as it had in the hands of the transferors. (Rev. & Tax, Code, §§ 24541, 24552.) If the transfer to appellant did not come within these sections, the basis for the property became appellant's cost. (Rev, & Tax, Code, § 24912.)

One of appellant's arguments in support of its position that there was no tax-free exchange is that at ail times after the transfer of the partnership assets to appellant, the combined interests of the three partners (the transferors) amounted to only 79.5 percent of appellant's totai voting stock, and that the "control" requirement of section 24521 of the Revenue and Taxation Code was therefore not net,

In reply respondent contends that the stock issued to Mr. Gallup was not issued as consideration for services which he had rendered to the corporation, but rather for services rendered to the partnership or to the individual partners prior to appellant's incorporation; that Mr. Gallup therefore received his stock as a nominee of the partners; and that his stock interest should properly be considered to have been received by the partners in determining whether or not they had the necessary control after the transfer occurred. If so considered, respondent concludes, the transferors owned 100 percent of the stock after the transfer.

Upon review of the entire record we are convinced that Mr. Gallup rendered valuable services to the corporation, or for its benefit, prior to the date when its stock was issued, Tile record indicates that Mr. Gallup was a competent executive on whom the partners relied heavily, to such an extent that none of then devoted any of their own time to the business. As the general manager of the partnership, he conceived and promoted the plan to incorporate and was doubtless active in working out the details.

Also, it was clearly anticipated that he would render substantial services to the corporation in the future, after obtaining a proprietary interest. Respondent's own regulation provides:

> Stock or securities issued for services rendered or to be rendered to or for the benefit of the issuing corporation will not be treated as having been issued in return, for property. (Emphasis added,) (Cal. Admin. Code, tit, 18, § 24521 (a), subd, (l)(A)(i).)

Under the circumstances we believe that Mr. Gallup received his stock from appellant in his own right, as consideration for services rendered and to be rendered to the corporation, and not from the partners, as their nominee. That being so, the partners never had the requisite control after they transferred the partnership assets to appellant and section 24521 of the Revenue and Taxation Code is therefore inapplicable.

In comparable fact situations the United States Tax court has concluded on several occasions that similar "tax-free exchange" provisions contained in the Internal Revenue Code did not apply. (Charles E. Curry, 43 T.C. 667; J. I. Morgan, Inc 30 T. C. 881; Warren H. Brown, 27 T. C. 27. See also, Columbia Oil & Gas Co., 41 B.T.A. 38, aff'd, 118 F.2d 459.)

We conclude that in computing its depreciation deductions for the years on appeal, appellant properly used the purchase price Of the depreciable assets as their basis.

O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor, Appeal of Tiger, Inc.

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 25667 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protests of Tiger, Inc., against proposed assessments of additional franchise tax in the amounts of $636.20, $636.20, and $1,013.23 for the taxable years 1961, 1962, and 1963 respectively, be and the same is hereby modified in that the basis for de-creciation of the property involved is to be regarded as $450,000. In ail other respects the action of the Franchise Tax Board is sustained.

Done at Sacramento, California, this 7th day of March, 1967, by the State Board of Equalization,

Paul R. Leake, Chairman

John W. Lynch, Member

__________, Member

Geo. R. Reilly, Member

__________, Member

ATTEST: __________, Secretary